



**Directorate of
Intelligence**

~~Confidential~~

25X1

Ret OEA 9698

East Asia in the 1990s: The Consequences of Economic Reform in China

25X1

An Intelligence Assessment

~~Confidential~~

*EA 86-10050
December 1986*

Copy **246**

Page Denied



Directorate of
Intelligence

Confidential

25X1

East Asia in the 1990s: The Consequences of Economic Reform in China

25X1

An Intelligence Assessment

This paper was prepared by [redacted] Office
of East Asian Analysis, with contributions from [redacted]
[redacted] Office of Global Issues, and [redacted]
OEA. [redacted]

25X1

25X1

25X1

Comments and queries are welcome and may be
directed to the Chief, Regional Issues Division, OEA,

25X1

Reverse Blank

Confidential

EA 86-10050
December 1986

Confidential

25X1

**East Asia in the 1990s:
The Consequences of Economic
Reform in China**

25X1

Scope Note

By assessing the economic impact in East Asia of successful, high-growth, economic reform in China, this paper tests the assumption that such reform will be a major force for stability in the Pacific Basin.

25X1

25X1

The reform process we visualize through the end of the century—wide-ranging, market-oriented policy changes that would produce a 7-percent average annual growth in the Chinese economy and open trade with the rest of the world—is not the most likely path for Beijing. Indeed, analysts in the Directorate of Intelligence believe that, even if the economic reforms are fully implemented, numerous bureaucratic and economic rigidities may prevent China from achieving the “miracle” growth registered by Japan in the 1960s and South Korea in the 1970s. Nevertheless, the Japanese and South Korean examples of xenophobic societies turning their economic energies outward suggest that a sharp break with China’s past should not be discounted too readily. In addition, analysis of the regional effects of the high-growth scenario is important for setting a benchmark for the more likely moderate, reform-induced, economic growth that China will probably experience over the next 15 years.

25X1

25X1

Confidential

25X1

**East Asia in the 1990s:
The Consequences of Economic
Reform in China**

25X1

Key Judgments

*Information available
as of 1 December 1986
was used in this report.*

Successful economic reform in China would confront Washington with both opportunities and threats. On the one hand, a more market-oriented China would serve US strategic interests:

- A China that sees its future dependent on the West will be less likely to lean toward the Soviets, and its increasing desire for markets, technology, and industrial supplies probably will make Beijing's foreign policy—which has been marred in recent years by border disputes with Vietnam and India—less contentious.

Far-reaching reform in China—although not the most likely outcome—could nevertheless create problems in East Asia that would hurt US interests there by the turn of the century:

- The vast expansion in Chinese exports that we judge reform would produce, and China's appetite for international capital, would adversely affect the rival economies of Australia, New Zealand, the Philippines, Indonesia, Malaysia, and Thailand. These countries export many of the same products—a mix of primary commodities and light manufactures—that China would export; further, they could not offset the damage by competitively producing the products—capital and high-technology goods—that China would import.
- Even though Beijing would be less beligerent, the political influence that would accompany China's rapidly expanding economic role in the region would probably increase longstanding security concerns in several East Asian countries—particularly Indonesia, Malaysia, and Vietnam. We believe such a development could create opportunities for Moscow to make both economic and political inroads.

China's rapid development would also produce major economic “winners” in the region. Japan, in particular, would probably garner a large share of China's expanding import market. Further, Japan is well poised to take advantage of high rates of return on capital invested in China because of its large trade surpluses and deregulated financial markets. The East Asian NICs (newly industrializing countries)—Hong Kong, Singapore, Taiwan, and South Korea—would benefit fully from China's growth if they continue restructuring their economies toward more capital intensive production—a process that would be reinforced, in our view, by China's growing economic presence in the region.

Confidential

Confidential

25X1

Under these circumstances, successful reform in China would sharply redistribute income in East Asia from the developing countries and Australia and New Zealand to Japan and the NICs. We believe that the losers in this process would react to Chinese competition by raising stiff barriers to imports in order to insulate their industries and workers from the detrimental effects of Chinese trade. The danger is that the resulting slowdown in economic growth in these countries could contribute to political tensions that threaten the stability of governments friendly to the United States.

In any case, Washington would face increasing pressures from the losers of reform in China to "make up" for their China losses. The developing countries, for example, would undoubtedly request additional aid and preferential trade to ease the economic pain associated with successful reform in China. Increased security concerns in the region would also lead some East Asian countries to look to Washington to provide a security buffer to the Chinese. In return they would probably show increased support for maintaining the US military presence in the Philippines.

25X1

Confidential

Confidential

25X1

Contents

	<i>Page</i>
Scope Note	iii
Key Judgments	v
The Jump Forward: A Profile	1
Impact of Reform on China	1
Winners and Losers in East Asia	4
Meeting Chinese Import Demand	4
Competition From Chinese Exports . . .	6
. . . And China's Thirst for Capital	7
Reaction in East Asia	8
Looking Inward	8
Security Concerns	10
Implications for the United States	10
Economic Opportunities and Constraints	10
Foreign Policy Gains and Risks	11
Estimating Chinese Trade Potential	13

Confidential

Confidential

25X1

East Asia in the 1990s: The Consequences of Economic Reform in China

25X1

The Jump Forward: A Profile

The Chinese economy has a huge and as yet untapped economic potential. China is well endowed with natural resources—such as coal, iron ore, and petroleum—has the largest labor pool in the world, and is free from the debt burdens of other developing countries. Experience in other Chinese-speaking countries, such as Hong Kong, Taiwan, and Singapore, attests to the work ethic and entrepreneurial spirit of Chinese culture and underscores the almost limitless possibilities that could be unleashed by market-oriented economic reforms. Double-digit growth in the Asian NICs (newly industrializing countries)—South Korea, Singapore, Hong Kong, and Taiwan—during the 1970s and 1980s sets a precedent for rapid economic development in China—a comparison not lost on Beijing's economic planners.

The growth potential of the Chinese economy ironically results from its current inefficiency as well as its large resource base. Because China's economy is one of the least efficient in the world, even small improvements in efficiency can increase output dramatically. The nonmarket character of the economic system distorts relative prices and wages, resulting in severe production inefficiencies, wasteful use of energy and other resources, and poor product quality.² State-set prices have been changed infrequently since the 1950s, and some goods pile up in inventory while others are in chronic shortage. Broad implementation of reforms would result in a more productive use of resources and the production of goods that could compete in world markets.

Our vision of successful reform—although not the most likely path for Beijing to take—thus includes “rationalizing” the price system so that prices and wages reflect supply and demand rather than government policy, and decentralizing economic decision making to the point that allows managers of firms to

react to changes in prices. A successful reform program would be wide ranging—reaching industry and urban areas, thus going well beyond the steps already taken toward commercializing agriculture. Moreover, in order to minimize the costs of reform such as inflation and large trade deficits, Beijing would move fairly quickly to improve the ability of economic technocrats to prime the economy with traditional monetary and fiscal policies used in developed countries.

25X1

Impact of Reform on China

The potential gains from further economic reforms are highlighted by the achievements produced by reform during the last several years, when Beijing began relaxing central controls: Chinese gross national product increased at over a 9-percent annual rate from 1980 to 1985; total trade nearly doubled, so that Chinese exports—at \$31 billion last year—are now the second largest among LDCs (see figure 1). Real incomes have increased by 50 percent, and Beijing's “open-door” policy has attracted nearly \$5 billion in foreign investment—more than in Thailand, the Philippines, and Indonesia combined.

25X1

One important effect of a more market-oriented system would be to significantly expand Chinese foreign trade. Although China's merchandise exports now amount to 7 percent of GNP, our statistical analysis suggests that China is severely undertrading. This is demonstrated by the surge in imports and exports that occurred as trade constraints were loosened in recent years. We believe a “normal” export share may be on the order of 14 percent, nearly double the current share (see appendix, “Estimating China's Trade Potential”). In such a case, with a 7-percent average growth in the economy, itself a consequence of the economic reforms, Chinese exports could expand nearly six times, to over \$175 billion by the turn of the century. Such an increase would boost

25X1

25X1

² China, for example, uses approximately twice as much energy and steel per unit of output as does the rest of the world.

25X1

Confidential**Table 1****China: The Ingredients of Successful Reform**

	Reform	Comment
Price reform	Allow prices and wages to be set in a free market. Progress has been made for over quota production, but the program needs to be expanded and extended to urban areas.	More efficient use of resources and higher product quality. Increase the availability of raw materials for industrial use. Of all the reforms, this is the most crucial.
Enterprise reform	Allow basic business decisions to be made by managers. Under this reform, the economic influence of local Communist Party officials and government ministries would be significantly curtailed. Reforms would progress far enough to allow market forces to discipline managers who make poor choices.	This is key to allowing firms to adjust to changes in prices and wages. Would make managers more responsible for their business decisions.
Labor reform	Expand the right of managers to hire and fire workers, as well as to reward superior skills and performance by increasing wages.	Would reduce waste and inefficiency by giving managers control over their most important factor of production. Also would improve the absorption of excess labor created by increasingly efficient agricultural production.
Policy reform	Establish economic policy controls. Requires tax and banking reform and a freely convertible currency.	Important to the reform program because it allows Beijing's economic technocrats to maintain economic stability while implementing the reforms. Establishing a convertible currency would be a major step toward eliminating foreign investors' concerns regarding profit repatriation.
Foreign trade reform	Further decentralization of trade decision making, including allowing enterprises to import and export without state approval.	Crucial to China's meeting its trade potential. Would direct resources to their most efficient international use.
Infrastructure improvements	Expand road, railway, port, and energy networks.	Although price and enterprise reforms will go a long way in alleviating transportation shortages by improving the efficiency of the system, Beijing must take an active role in easing the movement of goods.

25X1

Confidential

Confidential

Successful Reform in China: How Likely Is It?

Given the magnitude of the task, Beijing's implementation of the reform program is not likely to go smoothly. Indeed, the reform process will probably be "stop and go"—reforms followed by a period of government-induced retrenchment. This judgment is largely based on the emergence of problems such as inflation, ballooning trade deficits, growing price gouging, and fraud by low-level Communist Party officials already associated with the rapid implementation of major economic reforms. These problems arose full force in 1985, forcing Chinese leaders to call for a period of consolidation and adjustment in the reform program. [redacted]

Beyond this problem is the crucial question of political succession. It remains unclear whether reform-minded officials will be placed throughout the political structure to ensure the continuity of reform. Although a broadening of the coalition supporting reform is beginning—including farmers and more prosperous rural industrial workers, who earn three times as much as farmers—reformers are under pressure from political opponents to show better results from their policies. When the extent of last year's financial and pricing problems became evident, tensions within the leadership rose quickly—with conservatives attacking Deng Xiaoping and his supporters for excessively decentralizing economic

decision making and weakening the role of central planning. Discontent with the reform program has also surfaced in the form of protests by university students and popular grumblings about rising food prices. [redacted]

Even with a broadly based, proreform regime, China's fragile economic infrastructure could slow the progress of reform. For one thing, energy supplies in China are short, despite the sharp increases in production of coal, oil, and electricity last year. Moreover, additions to the transportation network have not kept pace with the growth in industrial output, and the system remains seriously overburdened. According to the Chinese press, factories must often suspend production because of shortages of electricity and delayed shipments of raw materials. [redacted]

Still, economic reform will play a key role in China's future. Beijing has learned that there is a high price to be paid for having a bureaucratic, command economy, and China's leaders want to avoid repeating the last 30 years. Not wanting to fall further behind the West, they realize that their national self-interest depends on modernizing and obtaining Western technology, and we believe they are pragmatic enough to take the necessary steps. [redacted]

25X1

25X1

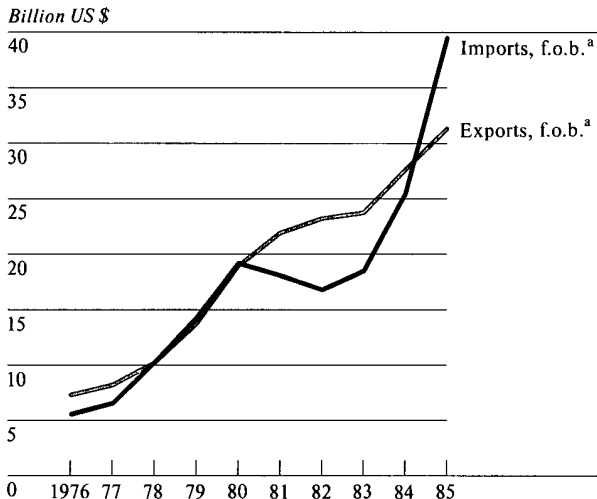
25X1

25X1

Confidential

Confidential

Figure 1
China: Exports and Imports, 1976-85



^aBased on partner trade data.

311247 12-86

China's share of the world market from under 2 percent to approximately 8 percent, a figure slightly lower than West Germany's and Japan's current share of the world market but larger than the United Kingdom's and France's.³ A different analytical approach—based on a study of Chinese resources—suggests that the potential export share may be even higher. In any case, although imports may lag slightly behind exports, they also have the potential to increase sharply.

The Chinese superiority in unskilled labor and natural resources indicates that Beijing would have a comparative advantage—the ability to produce a product more efficiently and at less cost than other countries—in exporting primary commodities such as crude oil, vegetables, soybeans, and cotton, and light manufactures such as textiles, clothing, and footwear.

³ This assumes that world trade grows at an annual rate of 2 percent.

Beijing is already moving aggressively to triple coal exports to 30 million tons annually—half of Australia's current coal exports—by 1990, and fast-growing Chinese exports will continue to include products such as consumer electronics, toys, and low-end-of-the-scale transport equipment, primarily ships.

At the same time, this development pattern would require that China import capital-intensive and high-technology products, such as high-strength and corrosion-resistant steels, electronics, aerospace equipment, and manufacturing machinery. Steel products—including sheet, bar, and pipe—would probably remain a leading Chinese import. In addition, China's lack of financial capital as well as the need to finance expensive infrastructure such as roads, electrical plants, dams, and communication facilities suggests that China would require large amounts of international financing—both in the form of loans and direct investment.

Winners and Losers in East Asia

The size of China's economy and its massive resources mean that successful reform would have far-reaching consequences for the rest of the world and particularly for the countries of East Asia, with which China now conducts nearly two-thirds of its trade. A larger Chinese economic role in the region would present its East Asian partners with both threats and opportunities, primarily in terms of export competition and expanded import markets in China.

Meeting Chinese Import Demand. We believe that Japan and the Asian NICs are well suited to meet growing Chinese demand for Western capital goods and high-technology products. Japan, South Korea, Singapore, and Hong Kong together have a 25-percent share of the world market in these products and a 58-percent share of the market for China's top 20 imports. Tokyo is already the largest exporter to

⁴ If the views of some China analysts are correct, including those published much of this overseas financing would be necessary because China will probably be unable to generate enough savings internally to meet growing investment requirements. Such a circumstance would be reflected on the trade side by current account deficits.

Confidential

Confidential

Trends in Chinese Exports and Imports

Exports. The main thrust of China's export drive will continue to come from the manufacturing sector. Since 1979 exports of manufactures have grown at nearly twice the rate of agricultural and extractive commodities, rising 16 percent per year in current dollar value and more than 20 percent per year in real terms. China's exports of manufactures are spread over a range of light industrial products—a wider range than any other developing country. China's potential appears greatest in labor-intensive areas such as textiles and clothing, metal products, hand tools, light machinery and transport equipment (shipped primarily to LDCs), handicrafts, footwear, glassware, crude chemicals, radios, and military equipment. As with many other developing nations, textiles and clothing are playing an important role, accounting for about one-fourth of China's total exports. China has had more success than any other LDC, however, in breaking into highly protected Western markets for these products. 25X1

Although agricultural exports will grow more slowly than manufactures, there are some crops for which dramatic increases are possible—corn, cotton, soybeans, and peanuts—if China shifts crop patterns to maximize the dollar value of the yields. For example, based on China's present yields and world prices, by shifting less than a hectare of land from wheat to cotton production, China could earn enough foreign exchange from exporting cotton to import roughly one hectare worth of wheat. Beijing intends to establish a series of export bases in coastal areas for growing these crops and probably will prove to be strongly competitive in selling them in the Asian market. 25X1

Imports. Capital goods and industrial supplies—the fastest growing imports—will continue to account for the largest chunk of China's import budget. Demand

for industrial supplies—such as steel, zinc, copper, fertilizers, and insecticides—will increase at a faster pace than the domestic economy can supply them. Our analysis shows that every 1-percent increase in industrial output results in a 1.1- to 1.3-percent rise in imports for the industrial sector. If industrial output rises 7 percent per year, imports of industrial supplies would grow at 8 to 9 percent per year. 25X1

Capital goods—which have always been the most variable component of China's total imports, falling in the early years of a five-year plan and rising sharply at the end—will probably increase dramatically in the next decade. In 1985, imports of capital goods—such as trucks, railway equipment, and road-building equipment—skyrocketed to more than \$17 billion, as Chinese enterprises rushed to complete projects scheduled under the last five-year plan and began gearing up for production in the next. 25X1

Growing Chinese purchases of consumer durables—such as televisions, motorcycles, and watches, from virtually a zero share of the world market—suggest a huge repressed demand for these products. As such, market-oriented trade reforms would lead to a rapid expansion in imports of such goods, which Beijing almost certainly will attempt to discourage. 25X1

Foodstuffs will probably remain a small share of imports in the future. Agricultural reforms have been so successful in boosting output that many of China's recent policies have centered on controlling rather than increasing production in order to reduce surpluses and storage costs and wastes. 25X1

Confidential

Confidential

China of these products, which include such items as steel, trucks, televisions, and plastics. []

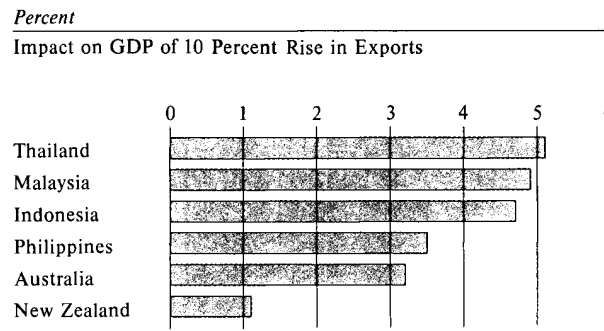
For the NICs to benefit fully from China's growing demand for imports, they will have to continue restructuring their economies toward more capital intensive production. In our view, China's presence in world markets will push the NICs further in this direction as traditional labor-intensive industries such as textiles—still an important source of export revenue for the NICs—face growing competition from China while new capital-intensive industries profit from sales to China. []

The history of the NICs suggests that they will allow, and even promote, the adjustment of their economies to this new world trading system. The process is already well under way in South Korea and Singapore. Electronics firms in Singapore, for example, have undergone considerable structural change over the past several years with the result that most local electronics producers have stopped producing black and white televisions. They are now concentrating on sophisticated testing and servicing of electronics products as well as beginning the delicate process of fabricating silicon wafers. The government has encouraged this restructuring toward higher, value-added production with a variety of policies including tax incentives and directing university students into scientific and engineering courses. A continuation of these trends would measurably enhance NIC export possibilities to the mainland. []

Competition From Chinese Exports . . . Rapid growth of light manufactured exports and, to a lesser extent, primary commodities from China would cut into other countries' export markets—in the United States, Western Europe, and Japan—and increase competition for the domestic market in most East Asian nations. If China were to reach its export potential, overseas sales would increase by nearly \$150 billion by the turn of the century—a level that would exceed the combined current exports of Indonesia, Malaysia, the Philippines, Thailand, Australia, New Zealand, and South Korea. []

The most vulnerable East Asian economies will be those that have a comparative advantage in the same type of products China will export. According to our

Figure 2
East Asia: Importance of Exports to GDP Growth



311248 12-86

analysis, these include the Philippines, Thailand, Indonesia, and Malaysia in manufactured and commodity exports and Australia and New Zealand in commodities. On average, 60 percent of these countries' export earnings are accounted for by China's top 20 export products. China's oil exports, for example, have already eroded Indonesia's market in Japan and Singapore. A reduction in export growth in these countries almost certainly would slow economic growth (see figure 2). According to our analysis, exports have a significant impact on economic growth in all of these countries except for New Zealand, and an export decline would have the most pronounced effect in Thailand, Malaysia, and Indonesia. For example, a 10-percent decline in exports from Thailand would lower that country's GDP by over 5 percent. []

In addition, a large increase in Chinese exports would reduce the prices of those products on world markets, leading to a deterioration in the terms of trade for the developing countries and for Australia and New Zealand—reducing the value of exports and contributing to slower economic growth. This trend would be

Confidential

Confidential

particularly painful for primary commodity exporters, especially Indonesia and the Philippines, whose longer term market outlook is already poor because economic growth in the United States, the EC, and Japan is no longer accompanied by commensurate increases in the consumption of basic materials, according to international economic analysts. []

Our analysis also suggests that bilateral trade balances between China and its regional neighbors will differ widely—a factor that would undoubtedly help determine the political responses in many countries to growing Chinese trade. Exports of light manufactures to New Zealand and Australia, with few imports from those countries, suggest that Beijing will show trade surpluses with Wellington and Canberra. On the other hand, because China's import of capital goods would be largely met by Japan and the NICs, and because their relatively small domestic markets will not purchase commensurate amounts of Chinese exports, Beijing would probably show trade deficits with the other dynamic East Asian economies. []

... *And China's Thirst for Capital.* We believe that Japan—with its large current account surpluses and growing interest in investing abroad—is particularly well positioned to meet growing Chinese demand for financial capital. Although Japanese firms have been cautious about investing in China, we believe major foreign investment reforms by Beijing would spur Japanese investment. Many of these investments would probably take the form of joint ventures, which are already an important source of financing for Beijing. Overall, 2,300 joint ventures had been approved by the end of 1985, drawing into China some \$4 billion in direct foreign investment, according to Chinese Government statistics. []

The large movement of capital into China would create business opportunities for commercial and investment banks, as well as for securities houses. Again, Japan—as well as more traditional banking centers in Hong Kong and Singapore—would probably garner a good share of the business. For example, China already has allowed foreign banks to begin operating in special economic zones, where banks are permitted to draw deposits from and extend loans to overseas customers, as well as service joint ventures in

China. Twenty-five percent of these foreign banks are Japanese, and the continuing deregulation of Japan's financial markets will go far in making Japanese financial institutions competitive with those in Hong Kong, Singapore, and New York for Chinese business. []

We also believe that, as a result of successful reform, China would increasingly look to acquire funds overseas both by borrowing from commercial banks and by floating bond issues in Western capital markets—something it has already done successfully in Japan, West Germany, and Hong Kong. []

[] China potentially could borrow more than \$25 billion over the next five years, and we calculate that if Beijing reaches its trade potential and allows its debt service ratio—the ratio of interest and principal payments to exports—to expand to even a modest 15 percent []

[] China's total debt could expand to nearly \$80 billion by the year 2000. The size of China's exports in this case suggests to us that Beijing would have little difficulty servicing its debt. []

In our judgment, much of this borrowing would come at the expense of developing countries in Southeast Asia, which will continue to require overseas funds to finance development. For one thing, competition for available funds would squeeze out marginal investment projects in the Philippines, Thailand, and Indonesia. Competition for funds is already heating up as Japanese investment in the developing countries stagnates while Japanese firms commit themselves to investment projects in China, as well as the United States and Western Europe. Jakarta, for example, has seen Japanese investment decline for two consecutive years. In addition, the World Bank—which made commitments worth \$3 billion to China from 1981-85—and the Asian Development Bank would probably provide Beijing large amounts of funds to finance infrastructure projects. This would directly reduce the amount of money available for other developing countries. Moreover, continued low debt service ratios imply that Beijing will maintain good credit ratings well into the 1990s, while the Philippines—and possibly Indonesia—struggles with poor ratings and thus higher interest rates. []

25X1
25X1

25X1

25X1

25X1

25X1

25X1

25X1

Confidential

Confidential

Chinese Trade: Impact on the Rest of the World

Although the economic impact would be less than in East Asia, the rest of the world would be affected in a similar manner by successful reform in China. Indeed, many developed countries—particularly those in Western Europe—would increase sales to China while developing countries watched Chinese exports cut into their markets in the developed countries. Western Europe's share of the Chinese market is far below its share of the world market for the same commodities that China imports—suggesting that there is considerable room for expansion. Only the largest European firms have put much effort into exploiting the Chinese market. Similarly, the non-Asian NICs should also do fairly well. By 1990, for example, China probably will be a leading purchaser of several of Brazil's exports, including plastics, pig iron, and fertilizers. Brasilia and Beijing have already agreed to technological exchanges in a variety of fields, including nuclear power development.

Meanwhile, economic growth of developing countries outside East Asia will be constrained by the rapid gains in Chinese exports. For many countries—including some of the poorest in Africa and Latin America—the export lines that China would be targeting for fastest growth account for a significant share of export earnings. On average, China's 40 fastest growing exports account for an estimated 40 percent of non-oil-exporting LDCs' foreign exchange earnings. They account for nearly 70 percent of the exports of South Asia, a region likely to be seriously hurt by China's trade expansion.

Reaction in East Asia

The overall economic effect of a much larger Chinese role in the world economy would be to hold down the growth of real wages and provide a boost to corporate profits in China's trading partners. This would reflect the large size and low wages of China's labor force—at 20 cents per hour, China's average wage is the lowest in East Asia and one of the lowest in the world—which would translate into low prices for China's labor-intensive exports and force competitors

throughout the region to try to hold down their labor costs.⁵ Beijing's large imports of capital-intensive goods would conversely increase the profitability of firms abroad involved in their production and export to China.

In our view, successful economic reform in China thus will lead to a redistribution of income within countries in East Asia as real wages stagnate while capital profitability increases. This will be particularly painful for the labor-abundant developing countries, including underemployment-ridden Indonesia and the Philippines where labor force growth rates of nearly 3 percent per year are the fastest in the region. In addition, income would also be redistributed to Japan and the NICs from the developing countries and Australia and New Zealand because these countries will face the brunt of Chinese export competition while providing little in the way of Chinese imports.

Looking Inward. If recent policymaking in the region is any guide, we believe that the political leadership of these countries may respond to the challenge by raising stiff barriers to imports in an attempt to insulate workers and industries from low-priced, low-wage Chinese products.⁶ Although protectionist policies—such as tariffs and quotas—will protect domestic industries and employment in the short run, they will do nothing to preserve export markets as overseas purchasers simply switch to Chinese products. On the contrary, protectionist policies may even damage export competitiveness, as local firms are forced to pay higher prices for imported capital goods and raw materials.⁷

⁵ China has more workers than all the OECD and CEMA countries combined. In just the next five-year plan, China must absorb 100 million new entrants into the labor force—an amount equal to the present size of the US labor force. Such trends suggest that real wages in China will remain very low.

⁶ Raising trade barriers was the overwhelming policy response of

⁷ Although an increasingly competitive China would be a critical factor for these countries, this would come at a time when they will also be facing other economic problems, such as growing protectionism in the West, debt service requirements, and adverse commodity price trends.

25X1

25X1

25X1

25X1

25X1

25X1

25X1

25X1

Confidential

Confidential

Table 2
Successful Reform in China: An East Asian Balance Sheet

	Benefits	Costs
Net winners		
Japan	Would supply much of China's import demand and financial capital, including telecommunications, electronics, and trucks. Already has a 30-percent share of China's import market.	Some Japanese industries, such as textiles, consumer goods, and agriculture, could face tough competition at home.
South Korea	A leading candidate to meet growing Chinese demand for capital-intensive goods. Seoul could triple exports to China with more open trade links. Could also become a marginal supplier of capital in the mid-1990s.	Traditional industries, such as textiles and shoes, would be hit hard by Chinese export competition, but Seoul will allow the economy to adjust.
Singapore	Would supply high-technology products and financial services to China. Could expand efforts to refine Chinese crude oil.	Traditional industries would suffer, but Singapore is further on the road to high-technology production than the other NICs. Tourism industry—which earned \$2 billion in 1985—may lose to the Chinese.
Hong Kong	Would be major funnel of Chinese trade. Hong Kong's banks would be key provider of financial services, and local firms would remain important investors in China.	Would face increased competition in export markets, particularly textiles, toys, and sporting goods.
Taiwan	Economically well positioned to sell to the Chinese market. Primary constraint would be political. Could be great opportunity for cooperation.	China would be a tough competitor for many of Taiwan's exports, including textiles, shoes, and toys.
Net losers		
Australia	Could be supplier of advanced mining equipment.	Exports—particularly coal and iron ore—would be hit hard; Australia's top 10 exports are all primary commodities. Could also lose resource investment dollars to China.
New Zealand	Marginal.	Primary commodity exports—particularly meat—would be constrained by Chinese exports.
Philippines	Could supply China with copper ore and wood.	Exports are vulnerable to overseas Chinese sales. Manila's markets for coconut oil would be adversely affected by Chinese soybean exports.
Indonesia	Could supply rubber and wood to Chinese market.	Would face tough competition in third markets for primary commodities. Jakarta has little alternative since extractives are the only products in which Indonesia can compete.
Thailand	Marginal supplier of rubber.	Export markets for textiles and vegetables would be vulnerable. As with all developing countries, Bangkok could lose foreign investments and commercial bank financing to China.
Malaysia	As the most advanced developing country in East Asia, Malaysia could be marginal supplier to the Chinese market, including such products as telecommunications and electronics.	Least vulnerable of the developing countries because of the growing diversity of exports. Nevertheless, primary commodities—such as palm oil—still account for the bulk of exports and would be vulnerable to Chinese competition.

25X1

Confidential

Confidential

Turning their economies further inward would exclude these countries from the additional economic growth that Chinese imports of capital goods would generate in Japan and the NICs because developing country competitiveness in those markets would slip further as protectionism rises. In addition, difficulty in obtaining overseas financing would worsen the balance-of-payments positions of the Southeast Asian developing countries and constrain economic growth by limiting the amount of capital equipment that they could import. Such developments would also force these countries into politically unpopular economic policy moves, such as devaluing their currencies or trimming government spending. Under these conditions, per capita incomes would probably continue to stagnate, and these economies would slide further behind in the regional economic race. The possibility that such a circumstance would lead to political turbulence that could threaten the stability of governments in those countries would be a matter of persistent concern throughout the 1990s. []

Security Concerns. A growing Chinese economic role in the world economy would almost certainly be accompanied by a greater Chinese political role in the region. For one thing, China's increased share of trade would give it a greater voice in international organizations such as the IMF and the Asian Development Bank. Most important, in our view, China would simply have a greater stake in the region as its economy becomes more dependent on economic and political developments there. A more politically assertive China is thus a likely consequence of successful economic reform in the region. []

Growth in China's economic and political influence, we believe, would probably cause serious strains in some Southeast Asian countries. Several countries are highly suspicious of China's long-term aims and would view the growing Chinese presence as a severe threat to their security. Vietnam—which has had continuing border confrontations with the Chinese for several years—will undoubtedly feel increasingly threatened by a successfully reforming China. Beijing's progress would be in sharp contrast to Hanoi's probable continued economic stagnation. Indonesia and Malaysia are particularly concerned about Chinese intentions—largely because of their deep-seated

resentment of local ethnic Chinese with ties to once-dangerous local Communist insurgencies, and a resulting fear in the capitals of both that their own Chinese populations have Beijing's interests at heart. Growing economic ties between ethnic Chinese populations in these countries and mainland Chinese would be viewed as especially threatening. []

Implications for the United States

Economic Opportunities and Constraints. Chinese economic expansion would create opportunities for US firms to boost their business with China, as well as to establish joint ventures in China. Prospects for US sales are good in knowledge-intensive and high-technology products such as coal-mining and oil-extraction equipment, hydroelectric plants, locomotives, aircraft, and computers. In addition, Beijing's interest in raising capital by selling bonds would open a large new market to US securities firms and banks. []

Indeed, prospects for US sales to China are probably better than past trends indicate. US exports have been held in check since 1980 by a number of factors, including the appreciation of the dollar and declining Chinese demand for grain. In 1980, with the dollar at a low, the United States occupied 20 percent of the Chinese import market, a figure that fell to 11 percent in 1984 when the dollar reached its peak. If the dollar stabilizes at current levels, we estimate that the US share of the Chinese import market could rise to 15 percent. Indeed, the United States currently has a 15-percent share of the world market for the commodities that China is buying. Still, US firms will face tough competition from Japan and the Asian NICs in the Chinese market, particularly for sales of heavy manufactures. []

China will almost certainly work to increase its relatively small share of the US market. Such a development would damage some US industries—such as textiles, clothing, and processed foodstuffs—and thus could be a source of friction in relations between Washington and Beijing. The Chinese are just beginning to mount a significant sales effort in the United States—the world's largest and fastest growing market for China's fastest growing exports.

25X1

25X1
25X1

25X1

25X1

Confidential

Confidential

China would be aided immensely if Beijing joins the GATT and becomes eligible for US Generalized System of Preferences tariff treatment—which could cover as much as 60 percent of China's exports. Should Washington move to restrict imports in general, friction with Beijing could rise because quantitative import restraints tend to favor more established suppliers over newcomers to the market. []

Foreign Policy Gains and Risks. The main benefits to Washington of successful reform in China would probably come in the strategic area. For one thing, a China that sees its future dependent on the West will be less likely to lean toward the Soviets. In addition, China's increasing desire for markets, technology, and industrial supplies probably will make China less contentious regionally, with Beijing working to avoid regional trouble such as its border disputes with India and Vietnam. In addition, rapid, reform-induced economic growth in China will give a strong signal to other developing countries that a more open and market-oriented economy might work for them also. []

Still, we believe that successful reform in China could create foreign policy opportunities for Moscow in the region. Although Indonesia, for example, will almost certainly look first to Washington, we cannot rule out the possibility that Jakarta's concern over the Chinese would encourage closer relations with the Soviets or even with radical Islamic states in the Middle East. Although in time Vietnam's concerns about China could lead to a rapprochement between Hanoi and Beijing, the short-term result, we believe, would be to force Vietnam further into the Soviet camp. Some political observers even suggest that, as China extends its reach in East Asia, Tokyo and Moscow may find it advantageous to strengthen bilateral relations in order to offset Chinese influence in the region, although we believe that Tokyo's first move would be to pursue even closer relations with Washington. []

In addition, the United States would face increasing pressures from the losers of reform in China—Australia, New Zealand, and the Southeast Asian developing countries—to “make up” for their China losses.

The developing countries, for example, would almost certainly request additional aid and preferential trade to ease the economic pain associated with successful reform in China. They would also look to Washington to provide a political and security buffer to the Chinese. In this regard, these countries are likely to show increased support for and interest in maintaining the US military presence at Clark Airfield and Subic Bay Naval Base in the Philippines. []

East Asian concerns about the Chinese could, in any case, put the United States in a position where it has to make tradeoffs between relations with most of East Asia and with China. With stagnant or declining world trade—the predominant view of most trade analysts—China's expansion in the US market can only come at the expense of other countries' exports, a development that would raise the level of frustration in regional capitals, particularly if Washington is unable to offset the damage done by an export-aggressive China. []

25X1
25X1

25X1

25X1

25X1

Confidential

Appendix

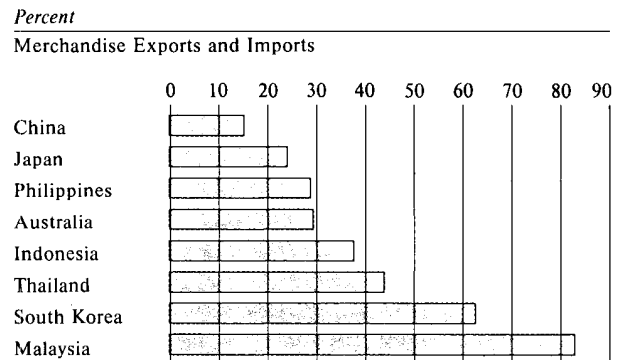
Estimating Chinese Trade Potential

We used two methods to estimate China's trade potential. The first is based on an econometric analysis of export-to-GNP ratios for 44 countries. This analysis argues that a number of factors determine what share of a country's output is likely to be traded, including the size of the domestic market, per capita income, the domestic availability of resources, the accessibility of the country to international shipping lanes, population density, and the nature of the economic system. By comparing these factors across countries, we estimate that China could be exporting twice as much—\$60 billion—as it currently does. Such a figure is 14 percent of China's current output, and it would put China's trade on a par with that of Italy and the Netherlands.

The second method—which indicates that China could export even more of its GNP—is based on an economic theory that argues that a country's trade potential depends on the composition of its domestic resources. In general, the more of a resource that a country has relative to other resources—such as labor or capital—the more competitive it will be in producing products that use that resource most intensively. The resulting comparative advantage in products that use such abundant resources enables a country to use overseas earnings from these goods to purchase products it cannot produce competitively, namely products that use its relatively scarce resources. Our analysis of Chinese resources—which indicates a very high ratio of unskilled labor and natural resources to skilled labor—suggests that China has the potential to export as much as 20 percent of its GNP. China's relative resource endowment appears to fall between those of the developing countries in Southeast Asia and those of the Asian NICs and thus a more market-oriented economy should result in China's export/GNP share rising and settling between the export shares of these countries (see figure 3).

The wild card in these analyses is China's terms of trade. As China expands trade it will have to give up more and more exports in order to get each additional

Figure 3
East Asia: Trade as a Percent of GDP



25X1

311249 12-86

25X1

unit of imports. Large Chinese exports of primary commodities and light manufactures will reduce the prices of these products on world markets. Similarly, large Chinese imports would drive up the prices of capital-intensive goods and high-technology products. The result would be a deterioration in China's terms of trade—the ratio of a country's export prices to its import prices—and a slowdown in growth. As such, the benefits of an extensive expansion in trade will become less clear to Beijing. The extent to which this would restrict China's desire to trade, we believe, would reflect the degree of the terms-of-trade decline and how much economic growth slows, both of which depend on many factors—including the future size of the world market for the products China trades and the structure of China's domestic economy.

25X1

25X1

Confidential

Confidential